

UKIP PARLIAMENTARY RESOURCE UNIT

Making Britain more productive



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Background

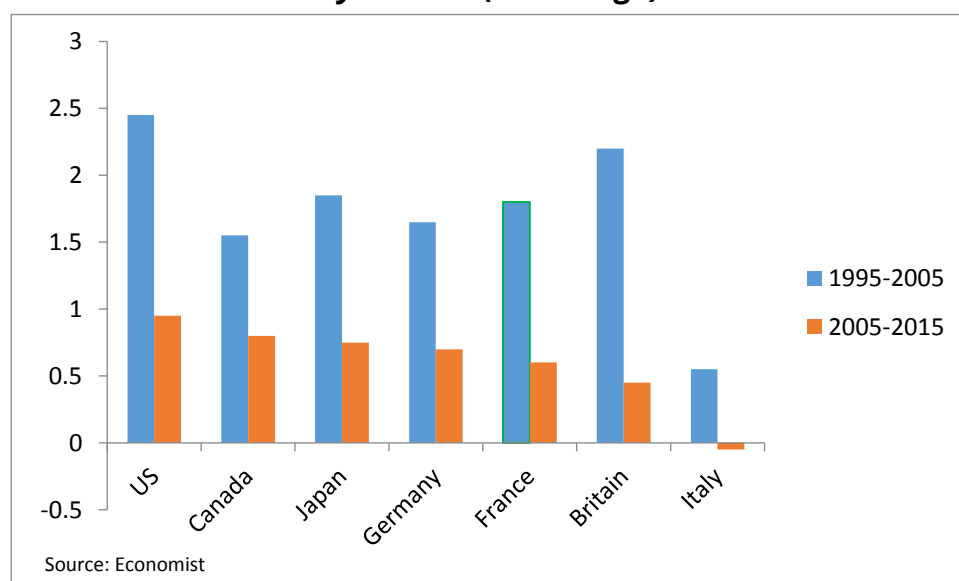
Productivity, generally defined as total output divided by total workforce (or number of hours worked), is the key driver of economic prosperity. Given that, it is poorly understood by most economists and few specialise in researching and understanding what drives it.

From 1945 to 1980 Britain performed relatively poorly in growing productivity. The United States pulled further ahead of us economically, while Japan and much of Western Europe closed the gap on us and then in many cases surpassed British productivity. The 1970s, which saw the UK join the then European Community and further adjust its trade patterns to Europe, saw particularly poor productivity performance in the UK, both in absolute and relative terms.

The 1980s, initially driven by large job losses, but later by strong output growth, saw a sharp improvement in UK productivity, again both in absolute and relative terms. Despite the 1990/91 recession that strong productivity record extended into the 1990s and early 2000s and was matched by rising living standards.

Since the mid 2000s the UK's impressive productivity performance has deteriorated sharply, once more both absolute and relative terms. In the decade between 2005 and 2015 UK productivity growth has averaged less than half a percent per year and has been near the bottom of the G7 table, surpassing only Italy. This contrasts with the previous decade between 1995 and 2005 during which UK productivity grew by over 2% per year and, amongst the G7, was surpassed slightly only by the US. That sharp drop-off in productivity performance was associated with a near 10% fall in average real wages in the UK between 2007 and 2014.

G7 Labour Productivity Growth (% average)



The Financial Crisis

A key part of the explanation for declining UK productivity growth since 2005 is undoubtedly the financial crisis of 2007-8.

The unsustainable expansion in bank lending prior to 2007, notably to the property sector, and the proliferation of synthetic financial products associated with it, led to an overstatement of underlying output and productivity growth between the early 2000s and 2007.

Some of the decline in productivity over the 2008-10 period was therefore inevitable. There was also a crisis response in both monetary policy, as interest rates were cut to 0.5% and quantitative easing started, and fiscal policy, as Alistair Darling increased government spending and cut VAT. This supported employment in the near-term as well as limiting corporate insolvencies.

Such crisis measures were justified in the short term. Many more people remained in work and far fewer indebted companies needed emergency restructuring. This prevented both a more general collapse in confidence and a sharper rise in unemployment, both of which could have weighed on output and productivity growth for many years to come. However, banks extending loans to keep more marginal companies in business, and a much smaller fall in employment than in output, led to a decline in productivity.

This should not have held back UK productivity in the long-term if those crisis measures had been unwound once the crisis period had ended. Unfortunately that has not been the case, and nearly a decade after the crisis commenced:

- only half of the government deficit has been dealt with, as government debt, far from being 'paid down', now approaches 90% of GDP;
- quantitative easing, rather than being reversed, or even gradually unwound as purchased gilts matured, was expanded in 2012, and now again in 2016; and
- interest rates were maintained at 0.5% for more than seven years and then cut still further.

The consequence has been that the financial system has to a significant degree stopped working to reallocate capital from unproductive uses to new, growing and more productive firms. Companies and projects which borrowed large sums at around 6% in the mid-2000s have had to service interest of barely 1%. A decade on many will not be the most productive custodians of capital. Yet, because emergency measures to cushion a crisis have continued, despite surging asset prices and near-full employment, zombie firms and banks weigh on productivity.

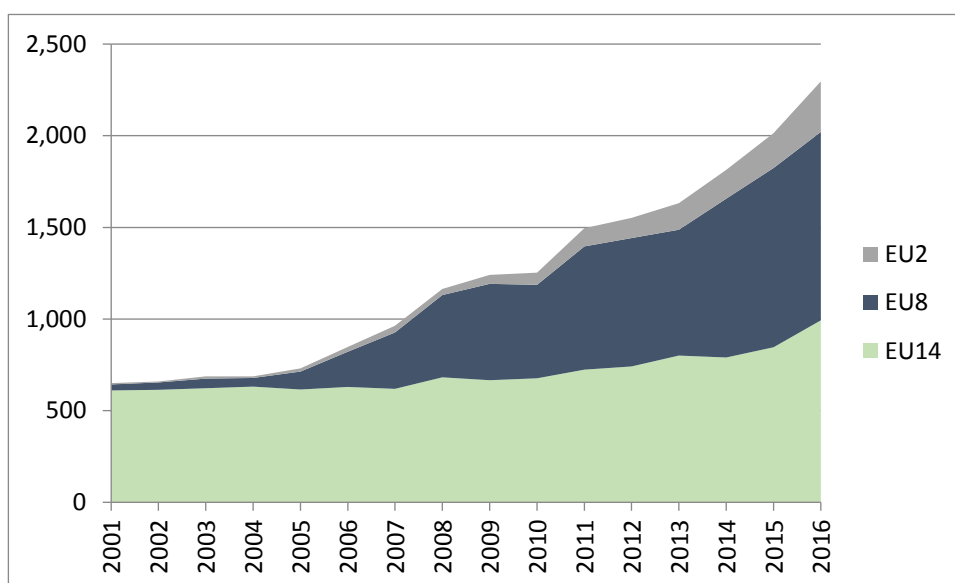
An Open Door to EU Labour

In his speech to the 2016 Conservative Conference Chancellor Philip Hammond said that the UK's poor productivity record *"means that millions of British workers are working longer hours for lower pay than their counterparts in Europe"*. That though is not the whole story, because UK productivity has been held down by millions of European workers joining the UK workforce.

Prior to 1997 net migration to the UK rarely exceeded 50,000 annually. From 1997 to 2003 that total increased, reaching 185,000 in 2003. In 2004, when the then Labour government chose to open the UK labour market to eight EU accession states, net migration rose to 268,000 and remained close to that level for a decade. It then rose further to 313,000 in 2014 and 334,000 in 2015, with the UK labour market having also been opened to Romania and Bulgaria (Source: ONS International Passenger Survey).

Over that period the proportion of total net migration accounted for by the EU rose to around a half. The number of EU workers (Source: ONS Labour Force Survey) increased from just over 0.6 million in 2004 to around 2.3 million by 2016. The make-up of the EU workforce in the UK also changed radically. There was only a small increase from older EU member states, largely since 2010 from poorer southern European countries suffering under the Euro. The big increase of more than a million new workers has come from the 2004 central and eastern European accession countries, and more recently Romania and Bulgaria.

EU workers employed in the UK



Over time and as they integrate into the UK, workers' productivity may improve but, given far lower incomes and productivity in the countries from which they have come, and the sectors in which they are employed, it is no surprise that this large labour movement into the UK has coincided with lower productivity growth.

Arithmetically, adding 1-2 million less productive, albeit hard-working, employees to the UK economy will weigh on average productivity. We see that those new workers have been disproportionately employed in sectors with high labour input relative to capital. We should also expect a dynamic effect since employers have less incentive for capital investment if there is no effective limit to the number of low wage employees they can import into the country. Why invest in an automatic car washing machine if migrant workers are exploited to do the job for less?

Subsidising lower paid workers

The UK has a good record on employment, creating more jobs than the rest of the EU put together. As well as reflecting a shift in workers from the rest of the EU to the UK, employment growth has been supported by the increasing extent to which governments have subsidised less well paid labour in the past decade and a half.

Government spending on tax credits is now around ten times great than what was spent on the Family Income Supplement equivalent twenty five years ago. The way tax credits are structured tends to subsidise employers of relatively low paid and less productive workers, raising employment but acting as a drag on productivity.

The nature of eligibility cut-offs at 16 or 24 hours work a week has also tended to incentivise jobs at or just above such a particular level, irrespective of what working arrangements may be most productive. If employees need to work a certain number of hours to receive a significant payment from government, employers may pay them less for marginal hours which are less productive but take them over that threshold.

Similarly, tax credit rules have supported a big shift in self-employment from higher to lower incomes levels over the past two decades. According to the Resolution Foundation self employment has increased by 45% to 4.8 million workers since 2001/2. Over the same period the average self-employed income has fallen from £300 per week to £240 per week.

It is only since April 2015 that HMRC have required the 'self-employed' claiming tax credits to "show that they are trading on a commercial basis and their business is done with a view to achieving profit" and insisted that "The self-employment should also be structured, regular and ongoing." Even now, HMRC only apply those requirements to new rather than existing claimants. It is not surprising therefore that rapid growth in

self-employment has been associated with much lower average reported incomes. These in turn feed through to official estimates for lower productivity.

The expansion in state support for childcare (or tax penalties for single earner families) has incentivised employment growth, but this may also have been at the expense of lower productivity growth.

To the extent that more mothers are attracted back into the workforce following childbirth, it is those whose financial decision is at the margin who are most likely to be affected. On average productivity will be less than for higher earners who may have returned to work without such childcare support. Moreover, wage levels and measured productivity within the expanded childcare sector are also low.

EU economic distortions

In a *Civitas* pamphlet entitled "*The Real Sterling Crisis: Why the UK needs a policy to keep the pound down*" published in September 2016 Roger Bootle and John Mills argue that an overly high exchange rate for sterling has reduced productivity growth in the UK.

The authors emphasise that investment in manufacturing has been lower with UK production less competitive on account of a strong pound supported by financial flows into the UK property and banking sectors.

A higher exchange rate will also have made the UK more attractive to the flows of migrant labour discussed above which have weighed on productivity growth. The need to service borrowing from overseas that has financed a current account deficit of some 6% of GDP may also weigh on future productivity growth.

The circa 15-20% devaluation since the EU referendum of itself makes the UK a significantly more attractive location for manufacturing investment. The trade balance will take time to improve in response to the more competitive exchange rate. However, the UK's highly significant investment income balance should already have improved sharply as UK foreign currency earnings will now be worth substantially more in sterling terms.

The drag of a 6% current account deficit can now be expected to ease. A relative shift in UK trade patterns away from the EU, where we run a trade deficit of more than £60 billion annually, to non-EU markets, where we run a surplus, would hold out the prospect of further improvement.

Finally, leaving the EU will also provide an opportunity to reduce the cost of productivity sapping regulation associated with EU membership, most recently calculated by *Open Europe* as £33.3 billion annually.